IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 89

AUTOMOBILE CLUB OF MICHIGAN, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

---

REPLY BRIEF FOR THE PETITIONER

RAYMOND H. BERRY,
A. H. MOORMAN,
JOHN L. KING,
1000 Penobscot Building,
Detroit 26, Michigan,
Attorneys for Petitioner.

Of Counsel:

ELLSWORTH C. ALVORD,
LINCOLN ARNOLD,
World Center Building,
Washington 6, D. C.

TABLE OF CONTENTS

CITATIONS

CASES:

IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 89

AUTOMOBILE CLUB OF MICHIGAN, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

---

REPLY BRIEF FOR THE PETITIONER

THE ISSUE OF RETROACTIVE REVOCATION[1]

A. The Commissioner's Attack on His Regulations

It is clear from respondent's argument (Br. 21-37) that the Commissioner makes no distinction, as petitioner asserted in its opening brief (p. 48), between a retroactive revocation of an individualized ruling of tax-exempt status—which an organization is required to apply for under the regulations—and a retroactive

---

[1] Petitioner will reply to the Commissioner's argument in the order in which the issues were discussed in the Commissioner's brief before this Court.

reversal of an interpretative ruling published in the Internal Revenue Bulletin, which some taxpayer may have read and relied upon.

The respondent's argument (Br. 21-24) evinces little or no respect for the regulations under section 101, on which petitioner has relied, even though it is customary for the Commissioner (at least when not in litigation) to urge taxpayers to obey and respect the regulations. While suggesting[2] (but not quite urging) that his regulations are invalid, the Commissioner certainly contends that his regulations should not be taken seriously, even by a taxpayer who has obeyed them and relied upon them.

While the regulations under section 101 (discussed and set forth in petitioner's brief commencing at page 44) most clearly provide that every organization claiming an exemption from tax is required to submit an application to the Commissioner for a ruling as to its tax-exempt status, and even though the regulations provide that when an organization has established its right to exemption it need not thereafter file income tax returns absent a change in the character of its organization or operations, the respondent contends (Br. 24): "These Regulations did no more than provide what kind of showing would be required to convince the Commissioner that the particular statutory provisions invoked by taxpayer were applicable."

---

[2] In disparaging his regulations, the Commissioner (Br. 27) referred to *Langstaff* v. *Lucas*, 9 F. 2d 691, 693 (W.D. Ky.), in which the District Judge stated that any erroneous interpretation of the law by Treasury Regulations could not estop the Government from asserting a tax even though the taxpayer may have been misled by the regulations. That case was decided before the decision of this Court in *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110.

Although the regulations provided that the information required of the taxpayer under the regulations would be submitted "to the Commissioner for decision as to whether the organization is exempt", respondent's brief (p. 27) states that the decisions made by the Commissioner in 1934 and 1938 as to petitioner's tax-exempt status "did no more than advise taxpayer that in the Commissioner's opinion, on the basis of the data submitted, the particular statutory provisions invoked by taxpayer did apply, and that, barring a change of circumstances, the Commissioner would not require additional data to convince him."[3]

In his attempt to belittle the regulations, respondent's brief (p. 26) quoted (but insufficiently) from the opinion of the Board of Tax Appeals in *Savings Feature of Relief Dept. of B. & O. R.R. Co.*, 32 B.T.A. 295. But the Board did not in that case, as suggested by respondent, hold that taxpayers need not or should not comply with the regulations under section 101. The Court stated: (at page 306)

---

[3] In an endeavor to exonerate himself, the Commissioner complains (Br. 41) that petitioner was the "moving party in the matter", and that petitioner "prepared and submitted evidence to the Commissioner in order to induce him (as it did) to issue the rulings in its favor". While it is hardly becoming for the Commissioner to blame petitioner for complying with the regulations, it can be pointed out that the petitioner was not the "moving party" with respect to the tax-exempt ruling given to petitioner on July 5, 1938. Although there had been no change of circumstances after the Commissioner in 1934 determined that petitioner was exempt from tax, the Commissioner on September 29, 1937, on his own initiative, requested petitioner to resubmit the proof of exemption called for under the regulations, and upon compliance by petitioner the Commissioner determined again (on July 5, 1938) that petitioner was exempt from filing returns. (R. 51, 59).

"The question of whether the Commissioner had the right to make the filing of proof of exemption a condition precedent to the right of exemption, need not be decided in this case. Even if the words of article 511 are to be interpreted as making the filing of proof of exemption a condition precedent to the right of exemption, still decision in this case must be for the petitioner. The petitioner, in March 1923 gave the Commissioner certain proof of its exempt character which complied at least in part with the regulations. Thereafter, more than eight years elapsed before the Commissioner made any move to assess a tax against the petitioner. Under such circumstances, a holding that the petitioner had forever forfeited its right to exemption would not be justified. Thus, whatever the correct interpretation of article 511 may be, the provisions of that article and its later counterparts afford no proper basis for denying exemption to the present petitioner."

The Commissioner, after he published his acquiescence in 1935 to this decision of the Board, continued to maintain that the regulations meant what they said. On May 12, 1945, the Commissioner mailed to petitioner Form 1025, the affidavit for organizations claiming exemption from tax. That form contained the following instructions from the Commissioner (R. 64-65):

"Unless the Commissioner has determined that an organization is exempt, it must prepare and file a complete income tax return for each taxable year of its existence. * * * As soon as practicable after the information and data are received, the organization will be advised of the Commissioner's determination, and, if it is held to be exempt, no further returns of income will be required."

In *Economy Savings and Loan Co.* v. *Commissioner of Internal Revenue* (6th Cir. 1946) 158 F. 2d 472,

where it was to the Commissioner's advantage to contend that the regulation—in providing that an organization need not file returns after it has established its right to exemption—should be applied literally, the Court held (at page 474): "This regulation has the force and effect of law".[4]

We point out again: The issue here is *not* the legal consequences of a *failure to comply* with the regulations, but the legal consequences of compliance.

---

[4] Respondent's brief (pp. 24-25, footnote 11) states that T. D. 5381 (1944 C.B. 188) *eliminated,* with respect to proof of exemption on or after January 1, 1943, the provision in the regulations which read: "When an organization (other than a mutual insurance company) has established its right to exemption, it need not thereafter make a return of income * * *."

Actually, the quoted sentence was not eliminated from the regulations under section 101. T. D. 5381, in order to conform the regulations with the Revenue Act of 1943 (which made the filing of Form 990 a statutory duty), merely changed the heading to the then existing regulations to read as follows: "Proof of exemption prior to January 1, 1943.—Annual returns for accounting periods beginning prior to January 1, 1943"; and the above quoted sentence was retained without change in the regulations for taxpayers who made proof of exemption prior to January 1, 1943.

T. D. 5381 also added a new section to the regulations with the following heading: "Sec. 29.101-2. Proof of exemption on or after January 1, 1943.—Annual returns for accounting periods beginning on or after January 1, 1943." The last paragraph in the new section provided (1944 C.B. 188, 192):

> "An organization which has established its right to exemption from tax under section 101, including *an organization which is relieved under* section 54(f) and *these regulations from filing returns of income* or annual returns of information, is not, however, relieved from the duty of filing other returns of information (see sections 147 and 148)." (Emphasis supplied)

Thus, the regulations under section 101, both before and after the amendment in 1944 by T. D. 5381, instructed petitioner that, having established its right to exemption, it was relieved from filing income tax returns.

B. The G.C.M. Was Not Notice to Petitioner

The Commissioner strenuously contends that the taxpayer received due notice in 1943 of the proposed revocation (or perhaps of the revocation itself!). (Br. 34-35). Suffice it to say that the record is silent. There is nothing in the record to support even an inference of notice. Both the Tax Court and the Circuit Court of Appeals below refused to accept the Commissioner's contention.

The Commissioner relies upon the publication of the General Counsel's Memorandum (G.C.M. 23688, 1943 C.B. 283). In view of his willingness to repudiate the regulations under section 101, it is not surprising that the Commissioner attempts to promote the legal status of a G.C.M. (Br. 14, 16, 21). However, no G.C.M. has or can have the force, effect, or dignity of a Commissioner's ruling or a Treasury regulation. An opinion from the Commissioner's General Counsel to the Commissioner for the Commissioner's consideration, which he may or may not follow, has in fact and in law no legal status whatsoever. Even the Internal Revenue Bulletin in which the G.C.M. was published fails to support the Commissioner's present position.[5] (The full text of the G.C.M. is set forth in an Appendix to

---

[5] The front page of the Internal Revenue Bulletin for 1945 stated: "The rulings reported in the Internal Revenue Bulletin are for the information of taxpayers and their counsel *as showing the trend of official opinion* in the administration of the Bureau of Internal Revenue; the rulings other than Treasury Decisions *have none of the force or effect of Treasury Decisions* and do not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury." (Emphasis supplied)

While Congress has provided that the publication of rules and regulations in the Federal Register gives legal notice of their contents (49 Stat. 502), neither the Congress nor the Treasury has made any such provision with respect to publications in the Internal Revenue Bulletin.

this brief.) Nor did the Commissioner himself consider it notice to the petitioner[6] nor even to the taxpayer involved.[7]

The G.C.M. itself establishes that it was not intended as a general notice, and certainly not as notice to the petitioner. Furthermore, it was based upon an unpublished decision with respect to the imposition of the dues tax (sec. 1710, Internal Revenue Code of 1939) upon dues to a health club. Neither before nor since the publication of the G.C.M. (throughout the 30 years of the existence of the dues tax there referred to) has anyone asserted that the dues tax applied to the dues paid to the petitioner.

C. The Commissioner's Denial of Discrimination

The Commissioner now contends that his arbitrary and unfair action (his contention, of course, being that the action was neither arbitrary nor unfair—Br.

---

[6] Neither the letter of June 11, 1934 (R. 48), nor the letter of July 5, 1938 (R. 59), in ruling that petitioner was exempt, suggested that the rulings were subject to revocation, retroactively or prospectively, by the publication of a G.C.M. (or even a general ruling by the Commissioner) in the Internal Revenue Bulletin. The Commissioner's letter of May 12, 1945, while referring to the G.C.M. (R. p. 59, 1st full par. p. 60), fails to claim that it gave notice and denies that it was a ruling. The Commissioner's letter of July 16, 1945 (R. p. 66) merely refers to the G.C.M. and properly labels it as an "opinion".

Had the Commissioner intended that the G.C.M. was notice to the taxpayer here involved, he would at least have stated what he sometimes states in other revenue rulings. See, for example, Rev. Rul. 209, 1953-2 C.B. 104, where the Commissioner tried to make the publication of Rev. Rul. 209 a revocation *for the future* of prior individual rulings with respect to the qualification as insurance of self-insured plans of employers.

[7] Although the record is silent, we have recently learned, and the Commissioner will not deny, that the taxpayer involved in the G.C.M. received a specific notice of revocation of its prior tax-exempt ruling by letter from the Commissioner dated June 11, 1943.

pp. 33, 34, 35) in refusing to follow the regulations and in his retroactive revocation of his rulings, was necessary (and therefore justified) in order that all the local automobile clubs should be treated alike. We admit that he has stated the only available argument. But since when has equality of treatment justified arbitrary and unfair treatment of a specific taxpayer? Seldom in the administration of the tax laws are all taxpayers, or even all taxpayers within a group, treated alike. This is particularly true when issues are involved in litigation. Rarely will taxpayers not involved in litigation suffer from a retroactive application of unfavorable judicial decisions. Usually, only the "guinea pig" is hurt.

But ~~let~~ us examine his assertion that all the clubs "be treated alike". Were they? Not one of the other clubs whose cases reached litigation was subjected to the treatment the petitioner received. In none of the other cases[8] was the issue of retroactivity involved. In none was there a retroactive revocation of a tax-exempt ruling.[9]

---

[8] *California State Automobile Association* v. *Smyth*, 77 F. Supp. 131 (Calif. D.C. 1948), reversed 175 F. 2d 752 (9th Cir.), cert. denied 338 U.S. 905; *Chattanooga Auto Club*, 12 T.C. 967 (1949), aff'd 182 F. 2d 551 (6th Cir.); *Warren Automobile Club, Inc.*, 8 T.C.M. 577 (1949), aff'd 182 F. 2d 551 (6th Cir.); *Keystone Automobile Club*, 12 T.C. 1038 (1949), aff'd 181 F. 2d 402 (3d Cir.); *Automobile Club of St. Paul*, 12 T.C. 1152 (1949).

[9] In fact, it cannot even be said, from a reading of the decisions, that any of the other automobile clubs involved had complied with the regulations and obtained a determination from the Commissioner that they were exempt from taxation. In the case of the California State Automobile Association, it is clear from the opinion of the Ninth Circuit (175 F. 2d 752) that the club had not previously obtained a ruling as to its tax-exempt status.

In the case of the other automobile clubs involved in litigation, it is clear that they were notified by the Commissioner, shortly after the publication of *G.C.M. 23688,* to start filing income tax returns. The Automobile Club of St. Paul (12 T.C. 1152) was the last of the auto club cases—except for petitioner's case—to be decided by the Tax Court. In the findings of fact by the Tax Court, it was stated (p. 1156) that the Commissioner by letter dated October 9, 1943 notified the St. Paul Club it was not exempt and would be required to file returns for 1943 and subsequent years. Since all of the other automobile club cases were decided before the St. Paul Club case, it is reasonable to conclude that they received their notice to start filing returns before, or at about the same time, notice was given to the St. Paul Club.

Petitioner's tax-exempt rulings were revoked in 1945, and the Commissioner is attempting to tax it for the two years preceding the year of revocation. None of the other clubs mentioned were taxed for any year prior to the year in which they received notice to start filing income tax returns.

Furthermore, the Commissioner did not require all of the clubs to "start paying taxes as of the same time". For example, the Chattanooga Automobile Club (12 T.C. 967) was not taxed by the Commissioner for the first nine months of 1943, but only for the taxable year beginning October 1, 1943 and subsequent years.

The *best* the Commissioner can claim is that he made a noble effort to treat *some* of them alike.

THE ISSUE OF THE STATUTE OF LIMITATIONS

A. The Statute of Limitations Started to Run on Due Date of Return

Since the Commissioner had instructed petitioner—both by his regulations under section 101 and by the letter rulings issued to petitioner—not to file returns, petitioner contends (Br. 73-77) that the statute of limitations started to run on the date when the returns were due if petitioner had been under a duty to file them. *Balkan Nat. Ins. Co.* v. *Commissioner of Internal Revenue* (2nd Cir., 1939) 101 F. 2d 75; *Stockstrom* v. *Commissioner of Internal Revenue* (App. D. C. 1950) 190 F. 2d 283.

The Commissioner relies (Br. 40) on two decisions in his argument. *Schafer* v. *Helvering* (App. D. C. 1936) 83 F. 2d 317, aff'd, 299 U.S. 171; and *Southern Maryland Agricultural Fair Association* v. *Commissioner* (1939) 40 B.T.A. 549. It will be noted that the Court of Appeals for the District of Columbia Circuit, which decided the *Schafer* case in 1936, relied on by respondent, nevertheless found and applied an estoppel against the Commissioner in holding (in 1951) for the taxpayer in the *Stockstrom* case. While the *Schafer* case was affirmed by this Court, the issue of estoppel was not presented to, or decided by, this Court.

In the *Southern Maryland* case, the Commissioner stated in his Notice of Deficiency (40 B.T.A. 549, 550) "The officers of your corporation since 1921 have been making distributions to stockholders contrary to the basis on which the exemption was predicated, and must reasonably have known that the ruling of January

18, 1924 was not based upon a full knowledge of the facts."[10]

It should also be noted that in its opinion the Board stated (p. 554) that the taxpayer "might well have cited" the *Balkan Nat. Ins.* case, *supra,* even though the taxpayer's case was "less strong factually". In petitioner's case, unlike in the *Southern Maryland* case, there was no misrepresentation or concealment which induced the Commissioner to issue the rulings that petitioner was exempt from filing tax returns.

The Commissioner argues (Br. 42) that it must be assumed that the parties, in signing the agreements for extension of the period of limitations, did not intend a futile act. Under section 276(b) of the Internal Revenue Code of 1939, no agreement for the extension of the statute of limitations is valid unless executed within the time prescribed by the statute. The intentions of the parties are immaterial. See *Atlas Oil & Refining Corporation* (1954) 22 T.C. 552, 560.

B. Form 990 Constituted a Return for Purposes of the Statute of Limitations

In discussing the decision of this Court in *Commissioner* v. *Lane-Wells Co.,* 321 U.S. 219, the Commissioner (Br. 43) points out that his regulations required a personal holding company to file a separate return on Form 1120H, and in its opinion this Court stated that the regulation requiring two separate returns was

---

[10] In the article "Taxpayers' Rulings" 5 Tax Law Review 105, by J. P. Wenchel, a former chief counsel of the Bureau of Internal Revenue, the author stated (p. 113) with respect to the *Southern Maryland* case: ". . . it appears that the facts had not been fully disclosed to the Bureau at the time the request for a ruling was made."

a reasonable and valid one, and the taxpayer had not complied with it.

But petitioner did comply with the regulations applicable to it. In filing Form 990, petitioner filed the only return form which the regulations required it to file.

The Commissioner contends (Br. 49) that the enactment of section 302(b) of the Revenue Act of 1950 indicates that Congress was of the opinion that the filing of Form 990 was insufficient to start the running of the statute of limitations. But section 302(b) did not say that a Form 990 will not constitute a return for the purpose of the statute of limitations unless it qualified under that section. Rather, the section prevents the Commissioner, in cases in which he had not already started proceedings against the taxpayers, from taking the position that Form 990 was insufficient to start the running of the statute of limitations. Congress left all other cases to be determined by the Courts on the basis of the existing law, and said nothing one way or the other as to how that issue should be decided.

Although the Commissioner stresses legislation in 1950, he fails to mention legislation in 1954. In the Internal Revenue Code of 1954 Congress provided, as the law for the future, that a Form 990 constitutes a return for the purposes of the statute of limitations. Section 6501(g)(2) of the 1954 Code provides as follows:

> "(2) Exempt Organizations.—If a taxpayer determines in good faith that it is an exempt organization and files a return as such under section 6033, and if such taxpayer is thereafter held to be a taxable corporation for the taxable year for which the return is filed, such return shall be deemed the

return of the corporation for purposes of this section."

The foregoing section was clearly intended by the Congress to *settle* the law prospectively. But it cannot be said that Congress intended the section to change the law. To the contrary. Paragraph (1) of section 6501(g) expressly provided, for the first time, that if a corporation in good faith determines that it is taxable as a trust and files a return on the fiduciary form, such return shall be treated as starting the running of the statute of limitations for the assessment of the tax imposed against corporations—a proposition decided by this Court in 1940 in the case of *Germantown Trust Co.* v. *Commissioner,* 309 U.S. 304. Obviously, Congress was codifying the law as to trust returns and deciding that the same policy should apply to tax exempt organizations.

THE ISSUE OF PREPAID DUES

A. Petitioner's Method of Accounting Reflects Income on Annual Basis

In its main brief, after discussion of the decisions of this Court with respect to the claim of right doctrine, petitioner pointed out (Br. 36) that this Court can sustain petitioner's contention that it is entitled to take prepaid membership dues into account for tax purposes in accordance with its long-established method of accounting without reversing or modifying any of its previous decisions. The Commissioner does not appear to take issue with the petitioner on this point.

While the respondent cites several decisions[11] of this

[11] *Spring City Company* v. *Commissioner,* 292 U.S. 182. (A debt for goods sold on open account became partially worthless by the end of the year. The accrual basis taxpayer sought to exclude

Court not discussed in petitioner's brief, none of them dealt with the application of the claim of right doctrine, and none of them presented a situation where the Commissioner refused to accept, as he has in petitioner's case, a long-established method of accounting consistently applied by the taxpayer. These cases cited by respondent dealt with the tax treatment of an isolated transaction or event of the taxpayer, and did not involve the issue of whether a general method of accounting adopted by the taxpayer and consistently applied from year to year, clearly reflected income for tax purposes.

Petitioner, of course, does not take issue with the proposition that under our tax system of annual accounting a taxpayer cannot postpone the assessment of taxes until it has been determined whether a given transaction engaged in during the taxable year resulted in a gain or a loss. Petitioner's case presents no such

---

the debt from gross income or, contrary to applicable law, to deduct the debt to the extent worthless.)

Burnet v. *Sanford & Brooks Co.*, 282 U.S. 359. (Taxpayer recovered an award to compensate for losses sustained from a long-term dredging contract. It sought to depart from its established method of filing returns on the cash basis and relate the award back over the years of the contract.)

Guaranty Trust Company v. *Commissioner*, 303 U.S. 493. (Involving the distributive income of a partnership filing returns on a fiscal year basis. Included in the taxable income of a deceased partner was the distributive income for the fiscal year ending in the year of his death and the income earned thereafter to the date of death.)

Heiner v. *Mellon*, 304 U.S. 271. (Involving distributive profits of a partnership formed to liquidate assets of a whisky distilling and storage business formerly conducted in corporate form. The partners sought to exclude the distributive profits from their annual returns until the final year of liquidation.)

issue. The petitioner has not substituted for an annual system of accounting a basis of "finally ascertained results of particular transactions", as the Commissioner argues (Br. 55). To the contrary, petitioner's method of keeping its books and filing its returns consistently reflects income earned and expenses incurred on an annual basis without regard to whether profit or loss is realized from particular transactions or from particular membership accounts.

The Commissioner's argument completely fails to meet the issue—whether the petitioner's method of accounting clearly reflects income. At no point in his Brief does the Commissioner contend that the petitioner's method fails to clearly reflect income. The Commissioner fails to take issue with petitioner's assertion that the Commissioner's method distorts income. Certainly, before the Commissioner is permitted to substitute his method of accounting for the petitioner's method, it is incumbent upon him to establish that his system *more clearly* reflects income than petitioner's method.

B. The Repeal of Sections 452 and 462

The respondent contends (Br. 61) that the *action of Congress* in enacting sections 452 and 462 of the Internal Revenue Code of 1954 and *in subsequently repealing those sections* makes clear the correctness of the Commissioner's position with respect to the tax treatment of the prepaid income in petitioner's case. The Commissioner commits two errors in making that contention. First, he forgets or disregards the written assurances given by the Secretary of the Treasury on March 22, 1955 to the Committee on Ways and Means that "the Treasury Department will not consider the

repeal of section 452 as any indication of congressional intent as to the proper treatment of prepaid subscriptions and *other items of prepaid income*, either under prior law or under other provisions of the 1954 Code. In other words, the repeal of section 452 will not be considered by the Department as either the acceptance or the rejection by Congress of the decision in *Beacon Publishing Co.* v. *Commissioner* (218 F. (2d) 697, C. A. 10, 1955) or any other judicial decision." (Emphasis supplied)[12]

The second error of the Commissioner is in concluding that the action of Congress in repealing section 452 makes clear the correctness of the Commissioner's position on prepaid income. Rather, the committees of Congress in charge of the bill (H.R. 4725, 84th Cong.) which repealed section 452 made it abundantly clear that they were not approving or endorsing the Commissioner's position. The views of the Committee on Ways and Means in this respect were set forth in petitioner's opening brief (p. 43).

The Senate Finance Committee in its report (S. Rep. No. 372, 84th Cong., 1st Sess.) expressed approval—rather than neutrality or disapproval—of the decision of the Tenth Circuit in *Beacon Publishing Company* v. *Commissioner*, (1955) 218 F. 2d 697, on which petitioner relies. After referring to the decision, the report stated (p. 5):

> "It is recommended to the Treasury Department that it modify its published ruling [I.T. 3369, 1940-1 C.B. 46] to the end that the remaining publishers may be entitled to defer prepaid sub-

[12] The letter of the Secretary of the Treasury, to the Chairman of the Committee on Ways and Means, containing such assurances, is set forth in H. Rep. No. 293, 84th Cong., 1st Sess., pp. 4-5 (1955-2 C.B. 852, 855). These assurances, of course, were given to the Committee on Ways and Means *before* Congress repealed section 452, and not *after* such repeal, as stated by respondent (Br. 64).

scription income so that they may be placed upon a *fair and equitable basis.*" (Emphasis supplied)

Moreover, the Senate Finance Committee report refutes the suggestion made by respondent (Br. 65, footnote 47) that there was an understanding by Congress that the settlement of the rules in the field of prepaid income and prepaid expenses should be left to Congress without help from the courts. In this connection, the Senate Finance Committee report stated (p. 5-6):

> "Uncertainty will also exist in other areas with the repeal of these two provisions. In *Pacific Grape Products* (C. C. A. 9th, February 10, 1955) [219 F. 2d 862], for example, the circuit court held that certain freight and shipping expenses incurred after the end of the year could be accrued for tax purposes as of the end of the year. An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed."

This statement does not indicate that Congress suggests—pending new legislation—that the courts abdicate and stamp approval to any position taken by the Commissioner in the field of prepaid income and estimated expenses. Rather, the Committee Reports express approval of the recent decisions (*Beacon Publishing Company*, and *Pacific Grape Products*) which rejected the Commissioner's position; disagree specifically with many of the Commissioner's actions; and state that Congress will correct the Commissioner's errors if and to the extent that the judiciary fails to correct them.

Sections 452 and 462 of the Internal Revenue Code of 1954 were repealed in 1955 when it became apparent

that the loss of revenue during the period of transition would be very much greater than had been estimated in 1954 when the sections were enacted (H. Rep. 293, *supra*, p. 3). While the Commissioner refers (Br. 64) to the loss of revenue which would have resulted, it is not believed that he is suggesting that a decision from this Court favorable to petitioner would create a similar problem.

The loss of revenue under sections 452 and 462 was purely a transitional problem. Taxpayers electing to use those sections could do so without obtaining the consent of the Commissioner to change their method of accounting for tax purposes. No revenue escapes tax when a taxpayer consistently files his returns under one method of accounting. But when consistency is abandoned, and there is a shift from one method of accounting to another, distortions will arise. If a taxpayer prior to 1954 was not filing his returns in accordance with the method described in section 452 or 462, his use of either section for 1954 would produce a decrease in the net income for the year as compared to what he would otherwise have reported without making the shift. The repeal of sections 452 and 462 gave Congress an opportunity to prescribe rules which would allow the shift with less effect on the revenues during the transition period.

But in petitioner's case there is no year of transition—it has kept its books since 1934 on one basis and filed its returns on that basis. Furthermore, if other taxpayers receiving prepaid income have been filing returns on the cash basis acceptable to the Commissioner, they cannot—upon the approval by this Court of the use by petitioner of its method of accounting—change to petitioner's method without first obtaining the consent of the Commissioner (a condition which,

as previously stated, was not required under sections 452 and 462).

Section 446 (e) of the Internal Revenue Code of 1954 provides as follows:

> "(e) Requirement Respecting Change of Accounting Method.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, *secure the consent of the Secretary or his delegate.*" (emphasis supplied)

The Commissioner's regulations will not permit a change in an accounting method unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. Section 39.41-2(c) of Regulations 118, the last regulations promulgated on this point, provide as follows:

> "A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, * * *. Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. * * *"

Thus, it is clear that the problem which occasioned the repeal of sections 452 and 462 cannot arise as a result of a decision of this Court holding that petitioner was entitled to take prepaid membership dues into income for tax purposes in accordance with its long-established method of accounting.

SUMMARY OF CONTENTIONS

For the convenience of the Court, we summarize the petitioner's contentions and attempt to summarize the Commissioner's contentions as we understand them:

I. The Retroactive Revocation Issue

(a) The petitioner contends that the Commissioner had no power to revoke, retroactively, the specific tax-exempt rulings issued the petitioner; that neither the statute nor the regulations confer that power; and that the regulations deny the power. The Commissioner contends that the rulings were founded upon a mistake of law; that they were merely advisory; and that they had no legal effect. The Commissioner also contends that power to revoke the rulings retroactively is found by implication in section 3791(b) of the Internal Revenue Code of 1939, and that the regulations under section 101 have no legal effect and should not be taken seriously, even by one who has complied with them and relied upon them.

(b) The petitioner contends that, even if the Commissioner had power to revoke, retroactively, the specific tax-exempt rulings, his action was arbitrary and discriminatory, without notice to the petitioner, in violation of his declared policy and long-standing practice, and that his attempt to revoke retroactively had no legal effect. The Commissioner contends that the publication of the General Counsel's memorandum in 1943 constituted adequate notice to the petitioner; that the petitioner doubtless received notice from one or more other automobile clubs; and that notice from the Commissioner was not required. The Commissioner asserts that his action was not arbitrary or discriminatory because it was necessitated by a desire to

treat all automobile clubs the same and that this objective justified his action.

II. The Statute of Limitations Issue

The petitioner contends that the statute of limitations bars the proposed deficiencies for the years 1943 and 1944; that the regulations relieved him of duty to file income and excess-profits tax returns for the years in question; and that in filing the tax-exempt return for each year in question, as required by section 54(f) of the Internal Revenue Code of 1939 (added by the Revenue Act of 1943), petitioner filed the only return he was required to file under the regulations, and that such return was "the return" within the meaning of section 275(a) of the Internal Revenue Code of 1939. Therefore, there was *no* "failure to file a return" within the meaning of section 276(a), and the three-year statute of limitations started to run on the date on which the income and excess-profits tax returns were due had the petitioner been under a duty to file them; that in any event the statute of limitations started running no later than the date upon which the return prescribed by section 54(f) and the regulations was filed; and the three-year period had expired. The Commissioner contends that only the filing of an appropriate income tax return and an appropriate excess-profits tax return meets the requirements of the statute, and that the statute of limitations cannot start running prior to the date on which such returns are filed.

III. The Method of Accounting Issue

The petitioner contends that its method of accounting, adopted in 1934 when petitioner was exempt from taxation and applied consistently since then, is a recognized and appropriate "method of accounting regularly

employed", within the meaning of section 41 of the Internal Revenue Code of 1939; that this method clearly reflects its income within the meaning of section 41 and is one of the methods recognized in section 42; that the method employed by the Commissioner distorts its income; and that none of the decisions of this Court are to the contrary. The petitioner also contends that the method employed by the Commissioner requires a reporting of its income from dues on a cash basis, and all its other income and all its expenses on the accrual basis, contrary to the decision of this Court in the *South Texas Lumber Co.* case. The Commissioner relies primarily upon the so-called "claim of right" doctrine; considers the failure to attempt to "match" the dues received with the obligations imposed upon the petitioner by its acceptance of the dues, merely an unfortunate consequence; and asks this Court to disregard the *Beacon Publishing Company* decision.

CONCLUSION

For the reasons stated in our main brief and here, it is respectfully submitted that the judgment of the Court below should be reversed with instructions to expunge the deficiencies found below for the years 1943 and 1944 and to compute petitioner's income from membership dues in accordance with the method of accounting employed by the petitioner.

Respectfully submitted,

RAYMOND H. BERRY,
A. H. MOORMAN,
JOHN L. KING,
Attorneys for the Petitioner.

Of Counsel:
ELLSWORTH C. ALVORD,
LINCOLN ARNOLD.

Dated: March 5, 1957

APPENDIX

G. C. M. 23688 (1943 C. B. 283)

Section 19.101(9)-1: Social clubs.

INTERNAL REVENUE CODE AND PRIOR REVENUE ACTS.

The M Association, functioning as a federation of automobile clubs and managing agency of several local automobile clubs, is not a "club" within the meaning of section 101(9) of the Internal Revenue Code and corresponding provisions of prior Revenue Acts, nor is it organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes within the meaning of that section.

G. C. M. 3555 (C.B. VII-1, 117 (1928)) and G. C. M. 2867 (C.B. VII-1, 115 (1928)) revoked. Recommended that O. D. 643 (C.B. 3, 241 (1920)) be revoked and that I. T. 2106 (C.B. III-2, 228 (1924)) be modified.

Reconsideration has been given to the status of the M Association as a club under the provisions of section 101(9) of the Internal Revenue Code and corresponding provisions of prior Revenue Acts. The status of the M Association (under the provisions of section 231(9) of the Revenue Act of 1926 and corresponding sections of prior Revenue Acts) was considered previously in G.C.M. 3555 (C.B. VII-1, 117 (1928)), in which the association was held to be exempt from taxation "as a club organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes."

The objects and purposes of the M Association (hereinafter referred to sometimes as the association) are stated in its by-laws, effective January —, 1941 as follows:

a. To aid in the establishment and maintenance of a uniform and stable system of laws relating to the regulation and use of automobiles and motor vehicles, and the rights and privileges of the owners and users thereof.

b. To promote the construction, maintenance, improvement, and supervision of highways that are safe, convenient, and accessible to motor vehicles.

c. To educate the users of motor vehicles and the public at large in the principles of traffic safety.

d. To collect and distribute information as to all matters or things of whatsoever character concerning motor vehicles, or of interest to the users thereof.

e. To conduct and participate in exhibitions, contests, and safety activities, and to offer and grant awards, in connection with the interests of the users of motor vehicles.

f. To organize, supervise, and grant affiliation to other corporations, associations, and organizations with objects and purposes similar to those of this corporation.

g. To engage in any activity permitted by law intended to further and protect the interests of the users of motor vehicles.

h. To do any and all acts or things incidental, necessary, or convenient to the accomplishment of these objects and purposes.

The M Association functions to a large extent as a federation of automobile clubs. It also functions as the managing agency of several local automobile clubs. In its capacity as a federation of automobile clubs until January —, 1941, the association recognized individuals as members of the organization. As of that date, however, it excluded individuals from membership by the following provisions in its by-laws, as amended:

Section —. Membership in this corporation shall be confined and classified as follows: (a) State associations, (b) automobile clubs, (c) automobile divisions, (d) commercial vehicle organizations.

Sec. —. Individuals who are, or become, affiliated with this corporation shall not be members, but shall be classified as regular and honorary associates, as hereinafter defined.

Prior to 1941, the by-laws made provision for membership as follows:

> Membership in this corporation shall be divided into six classes: (a) State associations, (b) automobile clubs, (c) commercial passenger motor vehicle organizations, (d) individual members, (e) divisions of this association composed of members thereof, (f) honorary members.

Other provisions of the by-laws define regular and honorary associates as individuals who reside in territory not covered by member organizations, or individuals elected as honorary associates, and state that such individuals, as such, shall have no right to vote in the affairs of the corporation, but shall have all the privileges extended to other individuals by the corporation.

In functioning as a federation of automobile clubs, the association represents member clubs in matters pertaining to the establishment and maintenance of uniform motor vehicle laws and fair and equitable taxation of motor vehicles. It fosters adequate marking of highways and other means of increasing the safety of motorists. It produces and sells on a cooperative basis to its member clubs highway and travel information such as maps, tour guides, travel directories, and other supplies for distribution by such clubs. It sponsors automobile races and conducts certified tests to the end that sound engineering practices will be developed, leading to the improvement of the automobile.

Member clubs pay to the association a specified amount per member obtained by each club during each month. Upon obtaining membership, such clubs are franchised to cover a particular territory within that served by the M Association and are given the right to vote in the affairs of the corporation, through duly selected delegates, at the rate of 1 delegate (1 vote) for every 1,000, or fraction thereof, paid-up members, except in the case of commercial

vehicle organizations as to which delegates are allowed on a different basis.

In its capacity as a managing agency of several local clubs, the association controls the activities of various clubs and divisions. In so far as those organizations are concerned, there is no difference between a "division" and a "club" except in name. One of them is operated as an experimental club, and the others have been operated by the association because of inadequate facilities within the territories covered by them. None of the above-mentioned clubs or divisions is incorporated. Each of the organizations is recognized as a member of the M Association and is given a right to vote in the affairs of the corporation. The individual members of such organizations are not recognized under the by-laws of the association as members of the association. However, as members of the local organization, such individuals have the right to vote within that organization and thus to participate in the selection of the delegates to represent the organization in the affairs of the association. The dues paid by individuals to the several local organizations become a part of the total revenue of the association, and the expenses of such organizations are paid out of the funds of the corporation.

When an individual becomes a member of one of the local divisions or clubs, the M Association, through the local organization, undertakes to render to such individual certain services in connection with his automobile, which services are intended to result in monetary savings to the individual. The association has made arrangements with numerous garages and service stations throughout the areas covered by the clubs and divisions under its control whereby emergency road service is furnished to members free of charge, such services being paid for by the association. The road services include, among other things, 30-minute repair service, towage in the event that road repair is impractical, tire changing, battery changing with

the use of a free-rental battery, and delivery service of gasoline and other materials. In addition, a member may have his lights and brakes inspected and adjusted without cost. In the event of theft of a member's car, the association offers a reward for the arrest and conviction of the thief. If a member is arrested or detained by reason of any violation of a motor vehicle law, with certain exceptions, the association will pay the cost of bail bond in any amount not exceeding a certain maximum. Personal travel information and services are also furnished by the association. Arrangements have been made with another corporation whereby members of some of the local organizations may purchase insurance at a considerable saving in premiums. Arrangements have also been made with certain merchants in one area whereby members of one of the local organizations may purchase clothing, laundry, furniture, and automobile supplies at less than the usual selling prices of such articles. There appears to be no limitation upon the number of individuals who may become members of the organizations managed by the M Association.

No material group activities are carried on or sponsored by the M Association. Though there may be some minor social activity, it is confined to small groups and is not a general activity of any of the local organizations. The above-mentioned services, which constitute a major activity of the organization, do not afford opportunities for personal contacts between persons receiving such services. They are services rendered to the individual wherever he may be and whenever he may need them.

Section 101 of the Internal Revenue Code provides that the following organizations shall be exempt from taxation:

> (9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder.

In G.C.M. 3555, supra, in reference to the instant organization, it was stated:

> Although the association may not be compared to a small social club which meets at stated periods for the purpose of discussing matters such as art, literature, etc., yet it is a club organized for nonprofitable purposes. The magnitude of the association is such that to apply the test of an ordinary social organization is impossible. The fact remains that it is an association of individuals organized and operated for the pleasure, welfare, and recreation of the members thereof, and not organized or operated for profit within the ordinary meaning of the term.

It is believed that the status of the instant organization should be reconsidered to determine whether the holding that such an organization is a "club" within the meaning of the statute is correct, and, if it is a club, whether it is organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes within the meaning of the statute.

Two approaches to the question will be considered:

(a) In G.C.M. 13067 (C.B. XIII-2, 148 (1934)), it was determined that the term "clubs," as used in an earlier counterpart of the above-quoted statute, was intended to apply to organizations having individual members and not to associations composed wholly of artificial persons or member clubs. The instant organization was there distinguished on the ground that it was composed in part of individual members. However, the present by-laws of the instant organization, as quoted above, have excluded individuals from membership. Accordingly, as an association whose membership is composed wholly of other organizations, it is believed that the M Association does not qualify as a "club," under section 101(9) of the Internal Revenue Code, since January —, 1941.

(b) Even if the individuals who are members of "clubs" or "divisions" were also members of the association, it

is believed that the organization would not qualify as a "club" within the meaning of the statute. Although there is no statutory definition of the term "club," as used in section 101(9) of the Code, it is believed that the term contemplates a comingling of members, one with the other, in fellowship. Thus, an organization should be so composed and its activities be such that fellowship among the members plays a material part in the life of the organization in order for it to come within the meaning of the term "club." Social activities among the members of the component parts of the instant organization are confined to small, random groups. No material group activity of any kind is carried on or sponsored by the association or any of its component parts, and it does not appear that there are any facilities for personal contacts among the members. It is represented that the "club" or "division" headquarters may be considered the "clubhouse" of each individual. While a clubhouse is not considered essential to the existence of a club, it does not appear that the headquarters, where practically the only activity is that of keeping records and dispensing personal information, would constitute a clubhouse in any real sense of the word. As the principal activity of the organization, with respect to the members of its component parts, is that of rendering personalized services in connection with the use of their automobiles, in the receipt of which each individual participates without contact with, or regard for, any other member, it does not appear that fellowship constitutes a material part of the life of the organization. It is to be noted, however, that fellowship need not be present between each member and every other member of a club, if it constitutes a material part of the life of the organization. In this respect, it is believed that a State-wide or Nation-wide organization, which is made up of individuals, but is broken up into local groups, satisfies this requirement if fellowship constitutes a material part of the life of each local group.

The term "clubs," as used in section 101(9) of the Code, supra, is used in the same sense as the term "club" is used in section 1710 of the Code and corresponding sections of the Revenue Acts relating to the taxation of dues or membership fees paid to "any social, athletic, or sporting club or organization." (See G.C.M. 13067, supra.)

In *Arner* v. *Rogan* (May 20, 1940, unreported), the District Court of the United States for the Southern District of California, Central Division, had occasion to consider whether the Biltmore Health Club was a "club" within the meaning of section 501 of the Revenue Act of 1926, as amended by section 413(a) of the Revenue Act of 1928 (now section 1710 of the Code). In concluding that the organization was not a club, the court said:

> * * * at least there must be some sort of association or cooperation between the members in an effort to reach some common objective before we may consider that there is a club or organization.

In the course or its opinion, the court observed:

> The evidence shows that members never met together or in committee and never participated in any activities which are normally carried on by members of clubs or similar organizations, nor is there evidence that the patrons were entitled by the terms of their contracts to so participate. * * *

Another factor given weight by the court was that:

> * * * the Biltmore Health Club did not in practice restrict its membership, nor did it agree to do so. The only qualifications apparently were that the applicant be over 21, white, free from any contagious disease or dangerous physical condition, and able to pay the fees.

The necessary implication to be derived from the Arner case is that financial contribution by way of a fee charged by the organization does not amount to "association or

cooperation between the members in an effort to reach some common objective," but that there must be some participation by the members in activities ordinarily carried on by clubs, which activities are intended to culminate in the realization of a common objective.

The evidence in the instant case does not indicate that members of the M Association participate in activities normally carried on by members of a club. Generally, the activities of the association may be classed in two groups, namely, those relating to the promotion of highway and motoring improvements and those relating to the services offered to individuals. In so far as the promotion of highway and motoring improvements is concerned, it does not appear that any substantial part of the local membership of the organization participates in such activities. Individual members, as such, have no right to vote or participate in the affairs of the corporation. The by-laws restrict voting rights to member organizations. In so far as services to individuals are concerned, members participate only to the extent of receiving such services. Although it might be contended that the receiving of services constitutes a common objective of the local members, it can not be said that members participate in activities leading to the rendition of such services, except to the extent that they make a financial contribution by way of a fee charged by the local organization. The principal activity of the M Association with respect to individuals, as stated above, is that of rendering services to motorists. Printed matter used in the solicitation of new members emphasizes the protection, service, and savings that accrue to members. It is reasonable to presume, then, that the actuating motive of individuals in joining the organization is to secure the convenience and savings afforded by services offered by the organization, and not to participate in any common objective proposed by the executives of the organization.

Although it should not be taken as the sole criterion, it is to be noted that no limitations are placed on membership by individuals. Organization members are limited to the extent that two franchises will not be given for the same territory. As to individuals, the organization is open to anyone who has not been convicted of manslaughter, negligent homicide, or hit-and-run or drunken driving, and who can pay the annual fee.

Upon reconsideration of the issue on the basis of the facts now presented, it is the opinion of this office that the M Association is not a "club," within the meaning of section 101(9) of the Internal Revenue Code and corresponding provisions of prior Revenue Acts.

Even though the association qualified as a "club" within the meaning of the statutes, it is not believed that it would be entitled to exemption as a club "organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes."

It is well recognized that exemption provisions, such as section 101(9) of the Code, supra, are to be strictly construed. In *Chicago Theological Seminary v. Illinois* (188 U.S. 662), the Supreme Court of the United States stated in part as follows:

> The rule is that, in claims for exemption from taxation under legislative authority, the exemption must be plainly and unmistakably granted; it can not exist by implication only; a doubt is fatal to the claim.

Under the rule of *noscitur a sociis,* the test of exemption is whether a club is organized and operated exclusively for pleasure, recreation, and other *similar* non-profitable purposes. It appears, then, that section 101(9) of the Code, supra, contemplates a club which devotes itself *exclusively* to activities in the nature of pleasure and/or recreation.

The principal activity of the M Association is that of rendering services to members in connection with the repair, maintenance, and use of their automobiles. In such respect, the organization operates in the nature of a nonprofit cooperative buying association. From the standpoint of the pleasure and recreation to be derived from the use of an automobile, most of the services offered are of the type available to motorists generally on a commercial scale at greater cost. Upon the payment of an annual fee, a member becomes entitled to free emergency road services which include such things as 30-minute road repairs, towage, tire changing, and gasoline delivery. In addition thereto, free services include brake and headlight adjustments, protection from car theft, and bail bond service. Insurance coverage is furnished at reduced premium costs, and members are able to make certain purchases at less than market price. In view of the above, it appears that the association operates to a material extent as a service club and is not engaged *exclusively* in activities in the nature of pleasure and/or recreation within the meaning of the statute.

It is not believed that section 101(9) of the Code, supra, was intended to exclude from Federal income taxation a club wherein the principal activity is that of rendering services of a commercial nature to members at a lower cost than would be paid elsewhere, even though the club derives no profits from such activity.

In view of the foregoing discussion and conclusions, G.C.M. 3555, supra, and G.C.M. 2867 (C.B. VII-1, 115 (1928)) are revoked, and it is recommended that O.D. 643 (C.B. 3, 241 (1920)) be revoked and that I.T. 2106 (C.B. III-2, 228 (1924)) be modified to conform to the views expressed in this opinion.

J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.